



Incorporating a Small Business

Incorporating a small business is a big step towards legitimizing your business, preparing for fund raising and reducing legal risk. This article reviews why you should incorporate a business, how to best use incorporate online services, and what goes into deciding where to incorporate (incorporate in Delaware or New York?). Your urge to incorporate your business should include a review of alternatives such as the limited liability corporation and s corporation. Finally, the article turns to “is it a good idea to incorporate a small business?” and concludes with an incorporating your business risk matrix table.

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Incorporate a Business, Incorporate Online! – Paper or Protection?

Why Incorporate a Business?

Today, you can incorporate a business online quickly and cheaply, just by filling out a form and clicking your mouse. A few weeks later you will get several pieces of paper and you are done. That said, most small business owners are not looking for more paper to stuff in the filing cabinet. They incorporate their businesses to save on taxes, secure their equity interests, and protect their livelihoods. If something goes wrong, they want to know that they still have the house...and steaks in the freezer!

Corporation – A State Authorized Legal Entity

A corporation is a legal entity that exists independent of its owners. Corporations only exist because one of the 50 US state’s law says that it can exist. It is as if your childhood imaginary friend has now become recognized by the state.

Let’s say you and your imaginary friend “My Pal Inc.” decide to set up a lemonade stand. You put it in the middle of the road so drivers can see it better. Somehow, a driver fails to see you and “My Pal Inc.’s” business, crashes into the stand, and totals his car.

When mom gets home, you’ll still be in trouble. But guess what? All you’ll lose is the lemonade stand and those old lemons you took from the bottom of the refrigerator. Why? Because the state says that “My Pal Inc.” is real, even if no one can see him. End result – you don’t get punished and if, for some reason, “My Pal Inc.” didn’t survive the crash, you’re always free to form “The Return of My Pal Inc.!”

Why Your Online Certificate of Incorporation and Bylaws Might Not be Enough

Here’s a formal explanation of what a corporation is: “A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. *Being a mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence.*” *The Trustees of Dartmouth College v. Woodward*, 4 Wheat. 518, 636 (1819)

Here’s what that second sentence is trying to say – if you, or the state corporation law, do not clearly say what your corporation can or can’t do, then the corporation may not be able to do the things that you want it to...or it may be doing things that you would rather it not be doing.

How do you tell your corporation what it can or can’t do? After you incorporate online, take your certificate of incorporation (the “look mom, I have a corporation!” paper) and your bylaws (the corporation’s rules and regulations) and carefully compare them to the corporate law in the state in which you incorporated. Depending on how you want to structure your business, you may have to make changes to your certificate of incorporation (“charter”) or bylaws. Changing your charter means

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another filing and another fee. Once your corporation has a board of directors and shareholders, you'll need director and possibly shareholder approvals to make changes.

Where the law does not clearly spell out an issue, you may want to clarify the situation by entering into a shareholders agreement. Visit the AbdulJaami, PLLC "Learning Center" (www.shajlaw.com) and download Treatment of Minority Shareholders and Negotiating Shareholder Agreements.

Incorporate Your Business - Alternatives

Limited Liability Corporation

What many people call a limited liability corporation is legally called a "limited liability company" or "LLC". An LLC provides the legal protection of a corporation (limited liability) while allowing the ownership, management and tax flexibility of a partnership.

Incorporate vs LLC

When thinking about the "incorporate vs llc" question, focus on three key areas: (i) federal taxes; (ii) company management; and (iii) capital structure.

Key Areas	Corporation	LLC
<i>Federal Taxes</i>	Income is taxed at the corporate level; Income is taxed when it goes to shareholders.	Members can choose to have income taxed at the LLC level, but usually don't; Income is taxed when it goes to LLC members.
<i>Company Management</i>	Board of Directors; Executive Officers – President, Vice President, Secretary, etc.	LLC Members can choose whatever management structure they want, including a corporate management structure.
<i>Capital Structure</i>	Corporate shareholders own stock; Common stock, preferred stock; stock can be separated into classes Class A, Class B... and series within classes	LLC Members own membership interests. Membership interests can take the form that LLC Members find most appropriate.

S Corporation

The S corporation starts out as a normal corporation (a C corporation). Shareholders of the corporation then decide ("elect") that they would rather not pay federal tax at the corporation level. They then file the necessary paperwork and formally elect to be taxed under the Subchapter S provisions of the Internal Revenue Code. The main benefit of an S corporation is that income is not taxed at the corporate level.

S corporations are subject to certain restrictions. They cannot have more than 75 shareholders. Non-US citizens that do not live in the US cannot be S corporation shareholders. S corporations cannot

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have corporations as shareholders. Finally, S corporations can only have one class of shares. Many of the benefits of an S corporation may be achieved with an LLC.

Incorporate Delaware or Incorporate in New York?

Where should you Incorporate your Small Business?

Most companies choose to incorporate in the US state in which they are located. This decision is sometimes made simply because it is the easiest, most convenient thing to do. Because corporations are governed by state law, and the USA has 50 states, differences in state corporation law may mean that it makes sense for some companies to consider incorporating in another state. Company business, tax, and legal issues should be carefully considered before deciding where to incorporate.

Many companies that incorporate out of state end up incorporating in Delaware, New York and Nevada (for tax reasons).

Incorporate Delaware?

Delaware is the undisputed home of US big business with 50+% of the fortune 500 companies and 40+% of NYSE listed companies being incorporated there. Why do they flock to Delaware? For a simple reason – when it comes to corporate law, Delaware is the most advanced state. Although corporations are regulated by state statutes, the US legal system is a common law legal system. Each of the 50 states has generated its own common law and some states are more business friendly than others.

Delaware is a state where there are many corporate common law legal precedents and judges have a great deal of experience with corporate law. While a trip to the courthouse is always unpredictable, strong legal precedents and experienced judges reduce the risk to some extent. And that's worth big bucks, for both the fortune 500 companies that call Delaware their home and also the State of Delaware which has turned its Secretary of State corporate division into a well-oiled corporation forming machine.

Incorporate in New York?

New York is also a state that many out of state and foreign companies choose to incorporate in. While Delaware is known as the capital of US corporate law, New York is the capital of contract and commercial law, especially when it comes to financial matters. For this reason, many companies choose to incorporate in the state of New York. New York State, in particular New York City, is home to some of the most commercially experienced courts and judiciary in the US and its reputation is known internationally.

Is it A Good Idea to Incorporate a Small Business?

A Good Idea to Incorporate a Small Business

Many small business owner's ask the question, "Is it a good idea to incorporate a small business?" The answer really depends on the business, tax and legal realities of the respective business. One benefit that is very attractive to a small business is the ability to insulate the business owner-manager from events that could severely negatively impact the owner-manager's personal financial reality. At the end of the day, you should analyze your particular situation with your legal advisor.



Incorporating Your Business

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Incorporating a small business is a big decision that will have a significant long-term impact on your company. The internet and “incorporate online” services have benefited everyone by making it much easier to file incorporation papers without leaving the office. This can also make it easier to execute a decision without fully informing yourself of the benefits and risks. The below Incorporating A Small Business Risk Table points out some common corporate problems, potential solutions and the benefits of the proposed solutions.

Incorporating a Small Business Table of Risks

Problem	Solution	Benefit
1. Need to formalize legally required election of directors; adoption of bylaws; opening bank accounts; subscription of shareholders; etc.	Hold state law required organization meeting; execute director resolutions; execute subscription agreements; execute shareholder resolutions	Preserve legal recognition of corporation; retain evidence of corporate formality to use if sued
2. Corporation to be managed by shareholders, not directors	Review corporate law for ability to implement; amend charter or bylaws if necessary	Shareholder-manager can manage corporate affairs without interference of board
3. Desire to limit or enhance voting powers of certain shareholders	Review corporate law for ability to implement; amend charter or bylaws if necessary; execute voting trust or voting agreement; enter into shareholder agreement	Shareholders have increased or decreased power to elect board members and control corporation
4. Give or deprive Board (or shareholders) the ability to take action without a meeting	Review corporate law for ability to implement; amend charter or bylaws if necessary	Board can be restricted or enabled to take action via written consent or conference call
5. Board/shareholders have too much power to sell company or affect value of company	Review corporate law for ability to limit voting rights and powers of board/shareholders; amend charter or bylaws if necessary; enter into shareholder agreement	Board/shareholders will be limited in ability to implement major corporate actions
6. Fear that board will vote to overcompensate itself and loot company	Review corporate law for ability to restrict board’s right to determine its compensation; amend charter or bylaws if necessary	Board will be limited in its ability to take exorbitant compensation
7. Fear corporate officers will loot company by taking 0-interest corporate loans	Review corporate law for ability to restrict corporate loans to officers and directors; amend charter or bylaws if necessary	Limit officers and boards ability to loot company
8. Shareholders want corporation but without many of the formal legal headaches	Review corporate law for ability to make a “close” corporation election; amend charter and bylaws	Owner-managers get limited liability, and can manage company without many corporate restrictions

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